

## REVIEW

*Corporate and Tax Aspects of Closely Held Corporations.* WILLIAM H. PAINTER. Little, Brown and Company, Boston, 1971. Pp. xiv, 501. \$30.00.

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Professor Painter's volume on the corporate, securities, and tax problems of the closely held corporation is lucidly written, well organized, and carefully simplified. The premise avowedly underlying the book's structure is that the "problems of business law cannot be broken down into the neat classical categories of corporate law, tax law, securities regulations, labor law, antitrust law, and so forth."<sup>1</sup> The author has not attempted to be a creator or innovator, but rather has performed the more modest function of collector and organizer. He is an excellent craftsman, and he has done well what he wished to do. The issues dealt with are discussed more in breadth than in depth. It is obviously not feasible, within a single volume, to refer to all pertinent authorities or to discuss each detail of the many and varied problems of the closely held corporation. The main outlines of various relevant areas are explored in the book, and reference is made throughout to the more exhaustive treatment of such topics in other treatises, such as O'Neal on closely held corporations, Bittker and Eustice on tax law, Hornstein and Cavitch on corporation law, and Loss on securities law.

Within his stated purpose, Professor Painter has been most successful. Whether the result will have broad utility and acceptance is another matter. It is hard to determine whether this is a how-to-do-it handbook, a graceful sort of hornbook, or some new form of text. For use as an adjunct to a course in business planning or even as a text for it (if supplemented by a series of problems), this will be a most valuable volume. As a semi-checklist for the practicing lawyer dealing with a closely held corporation or as an accountant's guide to the law of the closely held corporation, it will be quite useful. It is doubtful, however, whether it will be widely used by attorneys, since for most questions

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<sup>1</sup> P. vii.

it does not approach the depth to which most lawyers will probably want to pursue their research. The book contains insufficient footnote and reference material in most areas to enable it to be used effectively by lawyers as a springboard into the authorities. Lawyers with close corporation problems would in many cases be forced to resort to one of the more traditional "compartmentalized" treatises, which might lead many of them to regard Professor Painter's book as somewhat unnecessary.

The book has the virtues and the limitations inherent in its own approach. In covering an extremely wide area within a relatively short compass, it gives the reader an overview of its complex and interesting subject matter. To evaluate properly and place in perspective the material dealt with, however, the reader should optimally have had a prior knowledge of corporation, tax, and securities law; if the reader has a specific practical problem, then the skeletalized treatment of these various subjects probably will not provide an adequately penetrating or comprehensive treatment. For example, chapter IX deals with the first public financing of a closely held corporation and discusses, for forty-three pages, the advantages of public financing, methods of arranging for it, preparation of the registration statement, possible exemptions, private offerings, intrastate offerings, Regulation A offerings, and even state blue sky laws. In addition, the author provides in appendix C a detailed time schedule for the preparation, filing, and making effective of a registration statement under the Securities Act of 1933, and in appendix D he presents a lengthy example of a closing memorandum for a public sale through underwriters. The stated reason for including chapter IX is to describe an alternative method of obtaining liquidity in a closely held corporation. The question is inevitably raised in the reader's mind, however, whether this purpose could not have been better accomplished by pointing out that liquidity can be achieved through an offering of securities and then referring for the various technical aspects of arranging and consummating such an offer to an extended and more useful text on securities. Similar questions might be raised with respect to a number of topics considered in the book, including the material in the chapters on fringe benefits for employees of closely held corporations, tax aspects of mergers, consolidations and sale of assets, and corporate reorganizations.

Because the book does not purport to be comprehensive, it is not adorned with the customary and often pretentious paraphernalia of scholarship, namely, lengthy footnotes. Yet, in two chapters on maintaining control of the closely held corporation and on deadlock and dissolution, a much more extensive footnoting is provided. The reader

receives the impression either that these areas were intended to be the central core of the book, and were therefore buttressed with a greater panoply of erudition, or else that they are subjects on which Professor Painter has previously written, so that the impedimenta of scholarship were readily includable.

In these sections, as well as in the chapters on squeeze-out of minority shareholders, distribution and accumulation of corporate earnings, and buying out of shareholders, Professor Painter wisely concentrates on the difficulties to which a minority shareholder might be subjected, the areas of potential dispute and uncertainty, and the need for pre-planning and drafting of protective documents either to carry out the understandings of the parties or to provide for understandings the parties might not otherwise have adequately made. The treatment of these particular problems, although not as extensive as that of Professor O'Neal, is well handled and sufficiently comprehensive.

As an underlying philosophical position, Professor Painter chooses the view that stockholders of a closely held corporation should have almost free rein in negotiating desired objectives, as contrasted with the competing view that certain shareholder relationships are so subject to abuse that the state should lay down a policy limiting the ability of the parties to contract in those particular areas. In connection with the question of whether the beneficiaries of a voting trust can completely delegate their powers to the voting trustees, for example, he asserts: "In view of equitable limitations on the ability of a voting trustee to vote the shares against the interest of the beneficial holders, it seems better not to set statutory limits on the extent to which shareholders may delegate their voting powers and permit them to restrict, if they choose, the voting rights of the trustee on particular matters, with the assurance that they may receive equitable relief against actions which are oppressive or otherwise in breach of the trustee's fiduciary duty."<sup>2</sup>

Although I largely agree with Professor Painter's fundamental position, I have great reservations about the wisdom of relying heavily upon equitable limitations on the discretion of a voting trustee, because courts have too often been reluctant to monitor acts of business judgment in the absence of provable fraud. I would think that shareholders should give particular consideration to reserving some discretion to themselves on some important policy decisions, such as the question of merger or sale, by requiring a percentage vote of the stockholders.

After considering the problems indigenous to the closely held cor-

poration and outlining the difficulties of tailoring it to the rigidities of the general corporation law, Professor Painter in his last chapter examines the current close corporation legislation in the United States. Within very recent years, acts dealing separately with closely held corporations have been adopted in Florida and in South Carolina. Additional provisions of the general corporation law have similarly been enacted in Delaware, Oregon, Maryland, and Pennsylvania, authorizing, as the close corporation statutes do, separate treatment for closely held corporations and special status for stockholders' agreements, with various degrees of permissible deviation from the laws applicable to general corporations. Professor Painter favors legislative action that validates negotiated arrangements in closely held corporations, thus relieving such corporations of the rigidity of the general corporation structure. He expresses somewhat less enthusiasm for the completely separate statute, as distinguished from special enabling provisions.

The question of separate acts for closely held corporations is a live and important current problem that is receiving attention in bar associations and law offices throughout the country. Unhappily, there is little hard data on the operation of either type of special legislation for closely held corporations. One wonders what the practical effect of the separate statute has actually been. A recent recommendation to repeal the British statute relating to private corporations, coupled with indications that the Swiss private corporation statute and the Florida and South Carolina separate private corporation acts are not extensively used, suggest the need for empirical investigation. Professor Painter considers some of the objections that have been voiced to special legislation for closely held corporations and finds that "the reasons for resistance to legislation of this type are not entirely clear."<sup>3</sup> He reports, however, that this reluctance is said to be based upon a fear that separate legislation would impede the growth of small corporations and prevent "their evolution into publicly-held concerns." Also, he records the suggestion that corporate lawyers may discourage such legislation in order to prevent possible legislative attacks on the larger corporations, which could occur more easily if large and small corporations were treated separately. Professor Painter further suggests, as another possible reason for this reluctance, the difficulty of defining precisely what is meant by a closely held corporation, but he holds this objection to be of slight importance.

In view of its difficulty, I feel that the definitional problem deserves a little more attention and comment, even though I believe that

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such special legislation should be adopted. Professor Painter points out that closely held corporations have been defined in several different ways, either by specifying a given number of persons as determinative of whether the corporation is closed or public (Delaware and Pennsylvania), or by applying such legislation only to companies whose shares are "not generally traded in the markets maintained by security dealers or brokers" (Florida), or are not listed on a national securities exchange or regularly quoted in the over-the-counter market (New York), or are not regularly traded in any over-the-counter market (South Carolina). The Delaware and Pennsylvania statutes also require that all shares be subject to restriction upon transfer and that the corporation may not make any public offering of the shares, as that term is defined in the Securities Act of 1933. All of these definitions are somewhat vague and uncertain. Tying the status of a corporation, the validity of its agreements, and the enforceability of negotiated arrangements among shareholders to such concepts as "regularly quoted" or "generally traded" leaves one in a permanent morass of uncertainty. Tying the legality of these fundamental understandings to the concept of "public offering" is even more fearsome to anyone acquainted with the quagmire of esoteric ambiguity that surrounds private offerings under the Securities Act of 1933. Consequently, all of the present definitions of a closely held corporation do give a genuine and well-founded concern to any draftsman of such a statute. The recent Maryland statute eschews all of these number and trading standards in defining a closely held corporation as any corporation that has restricted transfer of its shares in a manner consonant with the statute. Under all of the definitions that do not use a numerical limitation, many large corporations having numerous shareholders may well be treated as closely held corporations, even though they would not be regarded as such in ordinary parlance. For example, a multimillion dollar corporation with five hundred stockholders, whose stock is not publicly traded, may be a closely held corporation under the laws of New York, South Carolina, and Florida; it could also be considered closely held in Maryland, unless the shares did not carry the requisite restrictions on transfer. By virtue of its exceeding the requisite numbers, however, it would be denied close corporation treatment under the laws of Delaware and Pennsylvania (as it would have been under the English law, from which the Delaware numerical test was taken).

In addition to the definitional dilemma, the problem of the termination or disruption of close corporation status merits serious consideration. Suppose a closely held corporation with twenty stockholders, after careful negotiation, sets up an elaborate series of arrangements—

for conduct of business, distribution of dividends, employment arrangements, voting of stock, directorships, etc.—that would be valid under a state's close corporation law but not under its general corporation law. If the test of a closely held corporation is a numerical one, what happens if one shareholder dies and leaves his stock to twenty legatees, thus raising the number of shareholders beyond the numerical limit in the statute? Do the special provisions remain binding and in effect, or is the corporation thereupon governed by the general corporation statute and the arrangements ipso facto terminated? Under a statute such as that of New York or North Carolina, can a stockholder who has signed agreements that are enforceable in a closely held corporation but that would be unenforceable in a public corporation free himself from the restrictions of these agreements either by effecting prohibited transfers or by causing other shareholders to create an over-the-counter market for securities of his corporation? The problems of protecting closely held corporation arrangements against disruption and of achieving suitable transition arrangements when a corporation ceases to be closely held—however that is defined—are significant. Such problems can, of course, be left to the courts for resolution on a case-by-case basis. But this process would create considerable confusion and probably lead to frequent cases of injustice. A legislative solution would be preferable and should be earnestly pursued. The Maryland statute, by buttoning the close corporation definition solely into stock restrictions, avoids many of those problems that arise from criteria based upon numbers or markets. Many persons find it anomalous, however, to conceive of a corporation as being closely held if it has a thousand shareholders—a situation that is possible under the Maryland Act. These obstacles can be successfully overcome; they should not debar close corporation legislation. They should, however, be recognized and considered in drafting and enacting such legislation.

Another objection that is strongly urged against special close corporation legislation is that recent state court decisions liberally upholding stockholders' agreements eliminate the necessity for such legislation. The argument is pressed that a decision such as *Galler v. Galler*<sup>4</sup> gives the corporate draftsman enough freedom in effectuating negotiated arrangements between parties, so that close corporation legislation is no longer necessary.

The *Galler* case upheld an agreement between two brothers and their wives providing for a number of arrangements that would be invalid in a publicly held corporation, including (1) mandatory divi-

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<sup>4</sup> 32 Ill. 2d 16, 203 N.E.2d 577 (1965).

dends, (2) an indefinite term for the agreement, (3) an even division of the four-man board between the two families, and (4) equal salaries between the two families. The Illinois Supreme Court, in enforcing the agreement, emphasized that it is now generally recognized that closely held corporations are sufficiently different from publicly held corporations to entitle them to special treatment. Although this case is a great step forward, so many questions remain unanswered that the bar and the business community should be given the benefit of the certainty provided by explicit legislative enactments. For example, in the *Galler* case, the court upheld an agreement for mandatory dividends out of accumulated earnings above the sum of \$500,000 in excess of stated capital. It is uncertain, however, what other kinds of mandatory dividend requirements will be enforced. It is difficult, for instance, to predict the result if mandatory dividends were provided without an obviously large reserve. On the question of the length of time such an agreement may last, the court said that the lack of a specified term of years was not fatal since insurance mortality tables indicated the life expectancy of the parties to the agreement. It is strange to find an agreement of this sort being tested by the ancient "life or lives in being" standard common to the rule against perpetuities; it is uncertain how this court might handle an agreement with a large number of signatories or one that geared its term to the lives of infants, trusts, or corporations. It also leaves open the question of the enforceability of such an agreement in favor of heirs, successors, and assigns.

The court further stated that the *Galler* agreement was enforceable because it had been signed by all of the corporation's stockholders; this leaves unanswered whether an agreement signed by less than all of the stockholders is unenforceable, or whether enforceability depends upon the percentage of stockholders who sign it or upon a relationship between its particular provisions and the percentage of stockholders who sign it. Parenthetically, it should be noted that when the *Galler* litigation began, ninety-five percent of the stock was held by the two branches of the Galler family and five percent of the stock was held by the firm's general manager, not a member of the family. After the commencement of the litigation, the manager sold his stock to one of the branches—the defendants, who were seeking to have the agreement held unenforceable. It is ironic to think that had the defendants not bought this stock, there would have been, at the time the case was decided, a stockholder who was not a member of the Galler family—a fact that, under the language of the court's opinion, might well have resulted in a decision declaring the agreement invalid, thereby sustaining the defendant's position.

In addition to the foregoing areas of ambiguity, the *Galler* decision leaves in uncertainty such questions as (1) what corporations are sufficiently "close" so that its liberality is applicable, (2) whether directors' action can be totally dispensed with and superseded by direct shareholder operation, (3) the status of agreements to arbitrate broad managerial disputes and deadlocks, and (4) whether such an agreement may be subject to some vague standard of fairness in its operation or some notion of equity on the part of the party seeking to enforce it. These kinds of questions raised by the *Galler* decision and similar cases indicate the desirability of legislation to provide greater certainty and reliability in stabilizing negotiated arrangements between shareholders of a closely held corporation.

The closely held corporation has often been described as an incorporated partnership; most of Professor Painter's book deals with attempts that have been made to transform the rigidity of the corporate form into a format resembling the more flexible type of partnership arrangement, while still retaining the corporate advantages of perpetual duration and insulation against liability. Perhaps consideration ought to be given to proceeding from the other end of the spectrum. It might be easier to achieve the objectives of the participants in a closely held corporation by restructuring the partnership device instead of attempting to soften the constraints of a general corporation statute. The advantages of perpetual duration and limited liability could be conditioned upon contribution by the partners of the specified capital, which could be publicized of record. Retention of this capital could be protected by imposing special limitations on diminution or distribution, analogous to those applicable to corporate capital. Barring any move in this novel direction, it would seem helpful to press for special legislation for closely held corporations that would make effective their special negotiated arrangements with greater certainty than now exists.



